

OFFICE OF THE AUDITOR GENERAL

235.1

PRELIMINARY REPORT ON WHOLESALE AND RETAIL
MILK PRICING STRUCTURE AS ADMINISTERED
BY THE DEPARTMENT OF FOOD AND AGRICULTURE

SEPTEMBER 1974

Joint Legislative Audit Committee

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September 16, 1974

The Honorable Speaker of the Assembly
The Honorable President of the Senate
The Honorable Members of the Senate and the
Assembly of the Legislature of California

Members:

Transmitted herewith is the Auditor General's preliminary report pertaining to the state-established minimum wholesale and retail prices for milk as administered under the California Milk Marketing Program within the Department of Food and Agriculture.

As of January 1, 1974, there were an estimated 810,000 milk cows and heifers on California farms which produced 10.3 billion pounds of milk in 1973. The volume of milk produced and sold is so large that a five-cent increase in the price of a half gallon of whole milk results in a \$66.5 million annual increase in cost to California consumers. As of June 6, 1971, the wholesale and retail price of milk in the Los Angeles area was 39.9¢ and 54¢ per half gallon, respectively. Since May 5, 1974, the wholesale and retail prices have been 55.6¢ and 71¢ per half gallon, respectively. This represents a 39.3 percent increase from 1971 on the wholesale level and a 31.5 percent increase from 1971 on the retail level.

The Director of the Department of Food and Agriculture is responsible for establishing minimum producer, wholesale and retail prices of milk.

A two-day statewide survey was conducted at 92 retail supermarkets throughout the major metropolitan areas of California. This survey disclosed that the gross profit (retail price less wholesale price) realized by the supermarkets from sales of milk at the state-established minimum retail prices generally is higher than the gross profit realized from sales of 11 other basic food items at non-regulated retail prices. The 11 other food items surveyed were baby food, condensed milk, powdered milk, creamed corn, catsup, tomato sauce,

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vegetable soup, sugar, flour, corn flakes and coffee. While the retail price of milk in all 92 supermarkets was sold at a gross profit, the retail price of all 11 other items resulted in a loss in from one to 54 of the supermarkets. Coffee was being sold at a loss in 54 of the 92 supermarkets.

The Auditor General has concluded that based on a limited two-day survey, the state-established minimum retail price for milk generally results in higher gross profits to retailers than the gross profits realized from the non-regulated retail prices for the 11 other basic food items in the sample.

State-established minimum wholesale milk prices place conventional milk processors (those not under common ownership with retail stores) at a competitive price disadvantage with vertically integrated milk processors (such as Safeway, which owns its own milk processing facilities and retail stores), and joint venture operations (combinations of a milk processor and independent retail grocery stores which jointly own and operate a milk processing plant). As a result, vertically integrated milk processors and joint ventures can, in effect, undersell conventional milk processors in the wholesale price of milk charged to retail supermarkets.

Since the retail outlets associated with both vertically integrated and joint venture operations are subject to state-established minimum retail prices, the efficiencies of these operations, which directly result in a decrease in costs, cannot be passed on to the consumers.

The Auditor General has concluded that it is not equitable to have state-established minimum wholesale milk prices to be charged to retailers by conventional milk processors, and not to similarly have such minimum prices to be charged to retailers by vertically integrated milk processors and joint ventures.

The panel, including the hearing officer, designated to hold state hearings on milk pricing and related issues, is comprised of Department of Food and Agriculture civil service employees, and includes no consumer or industry representatives.

The Auditor General has concluded that the composition of a panel which conducts public hearings pertaining to the establishment of milk prices and related issues warrants consumer and industry representation to insure that the views of all sides are adequately considered.

An estimated total of 420,000 gallons of raw skim milk was dumped by the California Milk Producers Association into sewage treatment facilities of the sanitation districts of Los Angeles County during June and July 1974. Surplus milk is normally processed into powdered or condensed milk.

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Two scheduled meetings requested by the Auditor General's staff with the California Milk Producers Association, to determine the reasons for dumping the milk, were cancelled by representatives of the Association.

The Auditor General has concluded that if a surplus milk situation occurs, reasonable efforts should be exerted to insure that such milk be processed into powdered or condensed milk in lieu of being dumped.

Respectfully submitted,

A handwritten signature in cursive script, appearing to read "Vincent Thomas", with a long horizontal flourish extending to the right.

VINCENT THOMAS, Chairman
Joint Legislative Audit Committee

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SUMMARY OF FINDINGS AND CONCLUSIONS

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FINDING

A statewide survey of supermarkets disclosed that the gross profit on milk resulting from the state-established minimum retail prices is generally higher than the gross profit realized on 11 other basic food items.

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CONCLUSION

Based on our limited two-day survey, we conclude that the state-established minimum retail price for milk generally results in higher gross profits to retailers than the gross profits realized from the non-regulated retail prices for the 11 other basic food items in the sample.

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FINDING

State-established minimum wholesale milk prices place conventional milk processors at a competitive price disadvantage with vertically integrated processors and joint venture operations.

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CONCLUSION

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FINDING

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CONCLUSION

If a surplus milk situation occurs, reasonable efforts should be exerted to insure that such milk be processed into powder or condensed milk in lieu of being dumped.

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INTRODUCTION

In response to a legislative request we have reviewed the pricing structure of milk as administered under the California Milk Marketing Program within the Department of Food and Agriculture. This program has as one of its functions the establishing of minimum prices for the sale of milk at the producer, processor (wholesaler) and retail levels.

This preliminary report concentrates on the Department of Food and Agriculture activities associated with the state-established minimum wholesale and retail prices for milk, and does not deal with milk pricing at the producer level.

BACKGROUND

The production and distribution of dairy products constitutes a major industry in California. As of January 1, 1974 there were an estimated 810,000 milk cows and heifers on California farms which produced 10.3 billion pounds of milk in 1973. Of the 10.3 billion pounds, 9.4 billion pounds were market milk, known commonly as grade A, and the balance was manufactured milk, commonly known as grade B. Grade A milk is produced under more sanitary and regulated conditions than grade B. The average annual production of milk per cow in California is 13,066 pounds which is approximately 30 percent greater than the national average and is reputed to be the result of superior herd management techniques and favorable weather conditions.

The volume of milk produced and sold is so large that a five cent increase in the price of a half gallon of whole milk results in a \$66.5 million annual increase in cost to California consumers. Milk production in California is concentrated largely in three geographical areas which are San Joaquin Valley, 52 percent; southern California, 30 percent; and the central coast counties, 10 percent.

Following are the price histories at the wholesale and retail price levels for half-gallon containers of milk in the Los Angeles area over the past three years:

Southern Metropolitan Marketing Area
(Los Angeles)

<u>From</u>	<u>To</u>	<u>Wholesale Prices</u>	<u>Retail Prices</u>
June 6, 1971	Feb. 1, 1973	\$.399	\$.54
Feb. 1, 1973	July 29, 1973	.418	.56
July 29, 1973	Aug. 9, 1973	.410	.56
Aug. 9, 1973	Oct. 14, 1973	.446	.59
Oct. 14, 1973	Nov. 1, 1973	.436	.59
Nov. 1, 1973	April 1, 1974	.481	.64
April 1, 1974	May 5, 1974	.534	.69
May 5, 1974	Present (Aug. 31, 1974)	.556	.71

Wholesale prices increased 39.3 percent between 1971 and 1974 while the retail prices increased 31.5 percent during the same period.

A brief analysis of the current price per half gallon of whole milk in the Los Angeles area, as of May 5, 1974 is as follows:

	<u>Share Of Retail Price</u>	<u>Percentage Of Retail Price</u>
Producer	\$.429	60.4%
Processor/distributor (wholesaler)*	.127	17.9
Retailer	<u>.154</u>	<u>21.7</u>
Total retail price	<u>\$.71</u>	<u>100.0%</u>

*At maximum order-size discount to retailer.

The California Milk Marketing Program does not regulate production. However, it does set quotas which affect the prices received by a dairyman. A dairyman may produce as much milk as his business judgment and his resources dictate. However, milk produced in excess of his quota results in a lower price being paid to the dairyman than milk produced within the quota.

Minimum fluid milk prices have been fixed at the producer level since 1935. Minimum wholesale and retail milk pricing was established in 1937. The Director of the Department of Food and Agriculture is responsible for establishing minimum producer, wholesale, and retail pricing of fluid market milk. Minimum prices to the producers are established by the department for each of the following classes of grade A milk based on statewide usage:

- Class 1 comprises fluid milk and any dairy product which by law must be made from grade A milk. This classification is comprised mainly of whole and low fat milk and yogurt.
- Class 2 comprises all fluid milk, fluid skim milk, or fluid cream used in the manufacture of a dairy product not included in class 1, class 3 or class 4. Examples are cream, cottage cheese and buttermilk.
- Class 3 comprises all fluid milk, fluid skim milk or fluid cream which is used in the manufacture of frozen dairy products, such as ice cream.
- Class 4 comprises all fluid milk, fluid skim milk, or fluid cream which is used in the manufacture of butter, hard cheese, dried milk and evaporated milk.

At both the wholesale and retail level, the minimum price of whole milk and low fat milk is regulated by the Department of Food and Agriculture. Other dairy items, such as yogurt, cottage cheese, and butter, are regulated only to the extent that the selling price may not be below cost.

Although no data is available which relates directly to per capita consumption of dairy products in California, the quantities of dairy products manufactured and sold represent reasonably well the quantities consumed. The 1973 per capita figures for sales and manufacturing in California are as follows:

Milk, Half & Half and cream	128.27 quarts
Cottage cheese	7.87 pounds
Buttermilk	2.78 quarts
Ice cream and other frozen products	22.72 quarts

FINDINGS

A STATEWIDE SURVEY OF SUPERMARKETS
DISCLOSED THAT THE GROSS PROFIT ON
MILK RESULTING FROM THE STATE-ESTABLISHED
MINIMUM RETAIL PRICES IS GENERALLY HIGHER
THAN THE GROSS PROFIT REALIZED ON 11 OTHER
BASIC FOOD ITEMS

As a part of this review, a major brand and common size of 11 basic foods were selected to be the basis of a market survey. Prices of these items, as well as the state-established minimum retail price for milk, were tested at 92 retail supermarkets throughout the major metropolitan areas of the state on August 20 and 21, 1974, and compared with wholesale prices in effect in those areas. The market sample disclosed that the gross profit (retail price less wholesale price) realized by the supermarkets from sales of milk is generally higher than the gross profit realized from sales of the other basic food items, at non-regulated retail prices, as shown in the Appendix.

It is grocery industry practice to frequently sell basic food commodities at a loss to encourage customers to shop at a particular store and, in the process, buy other higher priced items. Our survey showed that all of the 11 basic food items in the sample were being sold in at least one of the 92 markets at a loss, in that the retail price was below the wholesale price. One item, coffee, even had a retail price suggested by the wholesaler which would result in a "loss" to the store.

Due to the state-established minimum retail price, milk cannot be sold at a loss. The resulting gross profit (retail price less wholesale price) from the sales of milk is used in part to offset losses taken on other items. The Department of Food and Agriculture can establish minimum retail prices by determining the actual cost of handling milk at retail or by using the industry's overall cost of doing business with a statutory assumption that the cost of handling milk is the same as for other commodities. The department's efforts at determining the cost of handling milk have not been successful so, instead, they have used the industry's overall cost of doing business to determine retail markups.

Wholesale grocers normally require payment from retail stores for purchases within seven days. State regulations allow processors (wholesalers) of milk to extend credit for up to 60 days, and in most cases this is done. The value of the retail stores in San Francisco for these 53 days credit is 1-1/4 cents per half-gallon of milk, based on the current retail price for milk of 72 cents and the prime interest rate of 12 percent. The Department of Agriculture does not now consider this miscellaneous revenue accruing to the retail stores when setting the retail price of milk. Thus, in effect, the gross profit on milk is even more than was determined in our survey.

CONCLUSION

Based on our limited two-day survey, we conclude that the state-established minimum retail price for milk generally results in higher gross profits to retailers than the gross profits realized from the non-regulated retail prices for the 11 other basic food items in the sample.

STATE-ESTABLISHED MINIMUM WHOLESALE MILK
PRICES PLACE CONVENTIONAL MILK PROCESSORS
AT A COMPETITIVE PRICE DISADVANTAGE WITH
VERTICALLY INTEGRATED PROCESSORS AND
JOINT VENTURE OPERATIONS

The distribution of milk has changed dramatically in California since the milk marketing program began with the advent of vertically integrated processors and joint ventures.

Conventional Processors

Conventional milk processors (those not under common ownership with retail stores) are prohibited from selling milk to retailers at less than the state-established minimum wholesale price.

Vertically Integrated Processors

Vertically integrated processors, such as Safeway and Lucky, own their own milk processing facilities and retail stores and have achieved efficiency through their combined operations. Under the law, these vertically integrated firms are exempt from state-established minimum wholesale milk prices, even though their retail stores are subject to state-established minimum retail prices. As of October 1973, vertically integrated processors accounted for 29 percent of the statewide sales of fluid milk.

Joint Venture

A joint venture is a combination of a milk processor and independent retail grocery stores which jointly own and operate a milk processing plant. Earnings of this operation are proportionately distributed in the form of dividends

according to the amount of milk each retail member purchases. These dividends, if any, are in addition to the percentage of profit dictated by state-established minimum retail milk prices. Thus, joint venture operations are in effect not subject to the state-established minimum wholesale prices because they can offer retailers the added incentive of dividends based upon the volume of milk purchased through the joint venture. This lowers the price of milk to retailers below the state mandated minimum wholesale price.

The benefits and the efficiencies inherent in the vertically integrated processors and the joint venture operations, and therefore the resulting decrease in cost, cannot be passed on to consumers due to the state-established minimum retail prices for milk.

In order to compete with joint venture operations, which can in effect undersell them at the wholesale level, other conventional milk processors have sought relief from state-established wholesale minimum prices. To date, 15 percent of the statewide fluid milk production has been exempted from wholesale minimum prices, and another 20 percent is under consideration for exemption.

As a competitive device, Knudsen Corporation, a milk processor, entered into a joint venture agreement with Todds Food Company, a California corporation engaged in the processing and distribution of milk and the distribution of other dairy products and related non-dairy products. The State of California brought unsuccessful legal action against the Knudsen Corporation to preclude their joint venture device.

To compete with joint ventures who were offering the prospect of lower wholesale milk prices through possible dividends, the conventional fluid milk processors asked the Department of Food and Agriculture, Bureau of Milk Stabilization, to conduct hearings that would give consideration to the suspension of the minimum wholesale prices for fluid milk in some areas.

Public hearings were scheduled, and as a result of those hearings and other evidence gathered by the Bureau of Milk Stabilization, minimum wholesale prices for one gallon, half-gallon and quart containers were suspended until further notice in the following areas:

- North Central Valley, November 18, 1973
(Sacramento is a part of the North Central Valley, as well as Stockton and Modesto)
- Tulare - Kings Marketing Area, April 14, 1974
(Tulare and Visalia area)
- Kern County Marketing Area, April 14, 1974
(Bakersfield area)
- Central Valley Marketing Area, April 14, 1974
(Fresno area).

These four marketing areas represent approximately 15 percent of the total sales of fluid milk sold in California.

When the minimum wholesale prices were suspended in the Tulare-Kings, Kern County and Central Valley Marketing Areas, one of the area's fluid milk processors reduced the wholesale price to its consumers.

As a result, the retail supermarkets were purchasing their fluid milk at a lower cost than they had been when there were minimum wholesale prices in effect. Therefore, the gross profit on fluid milk at the retail level became greater, since the retail outlets were still subject to selling milk to consumers at the state-established minimum retail prices. To remedy this, on July 7, 1974, the Director of Food and Agriculture reduced the state-established minimum retail price for fluid milk in the Fresno area by three cents per half gallon so that consumers could benefit from the lower wholesale prices.

If additional marketing areas receive exemption from wholesale price minimums, retail price minimums must be removed or reduced if consumers are to benefit. On the contrary, in the Sacramento area, when wholesale price minimums were suspended, no similar change was made in retail minimums so the price of milk to consumers was not reduced.

The suspension of wholesale minimums is being sought by conventional processors who are attempting to compete with vertically integrated processors and with joint venture operations. As recently as September 4, 1974, a public hearing was held in Berkeley for the Central Coast Counties Marketing Area to give consideration to the suspension of minimum wholesale prices for fluid milk in that area. The Central Coast Counties is composed of such cities as San Francisco and Oakland.

If, as is now proposed, the minimum wholesale prices for fluid milk in gallon, half-gallon and quart containers are suspended in the Central Coast Counties in addition to the four marketing areas where the minimum wholesale prices have already been suspended, 35.6 percent of fluid milk for the entire State of California would be exempt from wholesale price minimums.

CONCLUSION

It is not equitable to have state-established minimum wholesale milk prices to be charged to retailers by conventional milk processors, and not to similarly have such minimum prices to be charged to retailers by vertically integrated processors and joint ventures.

THE PANEL, INCLUDING THE HEARING OFFICER,
DESIGNATED TO HOLD STATE HEARINGS ON MILK
PRICING AND RELATED ISSUES IS COMPRISED OF
DEPARTMENT OF FOOD AND AGRICULTURE CIVIL
SERVICE EMPLOYEES AND INCLUDES NO CONSUMER
OR INDUSTRY REPRESENTATIVES

The Food and Agricultural Code requires the Director of the Department of Food and Agriculture to hold public hearings when gathering evidence used to set the minimum wholesale and retail prices of milk.

The Hearing Officer is a civil service employee of the Bureau of Milk Marketing Enforcement. During the hearing, exhibits may be submitted and testimony presented. Witnesses are questioned by other civil service employees of the department who make up the "hearing panel". These civil service employees have daily contact with representatives of the dairy industry.

Members of most state boards and commissions include individuals which represent consumers and which represent the industry being regulated. The milk price hearing panel includes no consumer or industry representatives.

In a hearing on August 28, 1974, to consider the price of milk in the San Francisco Bay Area, consumer representatives stated that they were unable to obtain copies of the exhibits at the Oakland office of the department, as was stated in the notice of hearing. Department officials stated that copies were available in Oakland. No copies were available at the hearing. Department officials state that sufficient copies were placed on tables at the hearing, but that someone "stole" them.

To resolve the problem of the availability of exhibits for the public, the hearing officer announced after the noon recess that the hearing would be continued on September 4th, one week later, to allow the consumer representatives time to study the exhibits, which would again be made available at the Oakland office no later than August 30th. When a consumer representative objected and stated that five days which included a three-day weekend was insufficient time to allow their experts to study the exhibits, he was informed that September 4th was the only day that the meeting room was available. A check by the Auditor General's staff revealed that the only day that the meeting room was not available for the two weeks following the hearing date was September 17th.

CONCLUSION

We conclude that the composition of a panel which conducts public hearings pertaining to the establishment of milk prices and related issues warrants consumer and industry representation to insure that the views of all sides are adequately considered.

AN ESTIMATED TOTAL OF 420,000 GALLONS OF RAW
SKIM MILK WAS DUMPED INTO SEWAGE TREATMENT
FACILITIES OF THE SANITATION DISTRICTS OF
LOS ANGELES COUNTY DURING JUNE AND JULY 1974

Due primarily to the effect of temperature, the production of milk in California annually peaks during the months of May, June and July. To compound this problem of peak production, the consumption of milk declines during this period reportedly due to vacations and the increased use of alternative drinks such as iced tea and soft drinks. To handle this seasonal problem of peak production and reduced consumption, surplus milk is normally processed into powder or condensed milk.

The sanitation districts of Los Angeles County estimate that approximately 370,000 gallons of raw skim milk was dumped into the sewer lines by the California Milk Producers Association during June and July 1974. Due to the chemical reaction caused by the large volume of milk entering the system, problems resulted at the district's Long Beach Water Renovation Plant. Sanitation district officials requested the California Milk Producers Association to cease further dumping into the sewers, and provided the association with the option of either trucking the surplus milk to a sanitary landfill or to the Joint Water Pollution Control Plant in Harbor City where facilities existed to properly handle it. The latter site was chosen and during three days in July a total 51,900 gallons of raw skim milk was hauled to the plant and dumped. A representative of the sanitation district stated that a plant employee notified the press and the resulting press coverage discouraged further dumping after July 17, 1974.

Figures supplied by the Sanitation Districts of Los Angeles County estimate that the milk dumped by the California Milk Producers Association either directly into the sewers or hauled to the Joint Water Pollution Control Plant at Harbor City totaled 420,000 gallons.


The Auditor General's staff attempted on two occasions to meet with representatives of the California Milk Producers Association to determine precisely why the raw skimmed milk was dumped in lieu of being processed into powder or condensed milk and what steps have been taken, if any, to see that further dumping is avoided. Both of the scheduled meetings were canceled by association representatives. A recent trade journal indicates that the association is in the process of procuring a milk condensing facility.

CONCLUSION

If a surplus milk situation occurs, reasonable efforts should be exerted to insure that such milk be processed into powder or condensed milk in lieu of being dumped.

SUMMARY OF COMMENTS OF THE
DIRECTOR OF THE DEPARTMENT OF FOOD AND AGRICULTURE

1. One of our responsibilities is to make sure there are enough milk distributors to serve the public. If minimum retail prices are set too low then this would mean that stores in outlying areas might not carry milk.
2. The department would not object to a consumer and an industry representative on milk pricing boards.
3. The quantity of milk dumped in Los Angeles represents a very small percentage of the total milk production. The milk industry has very little waste compared with other agriculture industries. We are only aware of two dumping situations in the last five years. However, because persons dumping milk have not been required to report the dumping to the department, the department does not have a statewide total for the amount of milk dumped.


Harvey M. Rose
Auditor General

Date: September 13, 1974

Staff: Glen H. Merritt
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Results of August 21 and 22, 1974
Market Survey of 92 Retail Supermarkets

<u>11 Basic Foods</u>	<u>High Retail Price</u>	<u>Low Retail Price</u>	<u>Wholesale^{1/} Price</u>	<u>Number Of Stores Selling Items At a Loss</u>
Baby food - strained carrots (4-1/2 oz.)	.20	.13	.136	12
Condensed milk (tall can)	.43	.24	.276	1
Powdered milk (6 qt. size)	1.99	1.44	1.46	1
Creamed corn (303 can)	.39	.20	.27	16
Catsup (14 oz.)	.49	.28	.32	5
Tomato sauce (8 oz.)	.17	.11	.131	10
Vegetable soup (10-1/2 oz.)	.29	.18	.184	1
Sugar - granulated (5 lb.)	1.95	1.59	1.63	52
Flour (5 lb.)	1.29	.79	.918	39
Corn flakes (18 oz.)	.67	.49	.510	2
Coffee (1 lb.)	1.39	1.14	1.26	54
 <u>Whole Milk^{2/}</u>				
San Francisco - Oakland (1/2 gal.)	.72	.72	.574	0
Sacramento (1/2 gal.)	.68	.68	.555	0
Los Angeles (1/2 gal.)	.71	.71	.556	0
San Diego - Imperial County (1/2 gal.)	.71	.71	.567	0

^{1/} Wholesale prices are San Francisco prices. In computing numbers of stores selling items at a loss, wholesale prices in each area surveyed were used.

^{2/} Low retail prices of milk were state-established minimums in effect in each area. State-established minimum wholesale prices with maximum volume discount to supermarkets were used as the cost of milk.